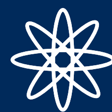

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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

This has been a lacklustre quarter for stock markets with equities drifting slightly lower and bonds showing weakness, whilst oil, particularly important for the world economy, has risen in price on various Middle Eastern issues. Sterling tended to strengthen slightly over the quarter and the weakness of the Australian dollar and certain emerging market currencies was a particular feature. Nevertheless, for the year to date, equities have so far shown a pleasing advance.

The tables below detail relevant movements in markets :

International Equities 31.05.13 - 30.08.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.2	-4.2	-2.3	-4.0
Finland	+1.6	+1.4	+3.4	+1.6
France	+0.5	+0.2	+2.2	+0.5
Germany	-2.5	-2.7	-0.8	-2.5
Hong Kong, China	-3.3	-5.1	-3.2	-4.9
Italy	-2.2	-2.5	-0.5	-2.2
Japan	-2.4	-1.6	+0.5	-1.3
Netherlands	+2.2	+1.9	+3.9	+2.2
Spain	+0.9	+0.6	+2.7	+0.9
Switzerland	-2.4	-1.5	+0.5	-1.3
UK	-1.4	-1.4	+0.7	-1.1
USA	+1.0	-1.0	+1.0	-0.7
Europe ex UK	-0.9	-1.3	+0.7	-1.0
Asia Pacific ex Japan	-0.4	-5.1	-3.1	-4.8
Asia Pacific	-1.4	-3.4	-1.4	-3.1
Latin America	-6.0	-14.8	-13.0	-14.5
All World All Emerging	-4.2	-10.0	-8.2	-9.8
The World	-0.1	-1.9	+0.1	-1.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -2.6%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	31.05.13	30.08.13
Sterling	2.03	2.79
US Dollar	2.17	2.76
Yen	0.86	0.73
Germany (Euro)	1.51	1.86

Sterling's performance during the quarter ending 30.08.13 (%)

Currency	Quarter Ending 30.08.13
US Dollar	+2.0
Canadian Dollar	+3.7
Yen	-0.7
Euro	+0.2
Swiss Franc	-1.0
Australian dollar	+9.9

Other currency movements during the quarter ending 30.08.13 (%)

Currency	Quarter Ending 30.08.13
US Dollar/Canadian Dollar	+1.7
US Dollar/Yen	-2.6
US Dollar/Euro	-1.8
Swiss Franc/Euro	+1.2
Euro/Yen	-0.9

Significant Commodities (US dollar terms) 31.05.13 - 30.08.13 (%)

Currency	Quarter Ending 30.08.13
Oil	+13.6
Gold	-0.4

MARKETS

International equity markets have drifted slightly lower over the quarter mainly due to concerns about the possibility of the US Federal Reserve soon starting a programme of tapering the quantitative easing programme which it instituted following the financial and economic crisis of 2008. Investors have known that, at some stage, this would have to happen yet the merest hint from Mr. Bernanke that tapering could start soon disorientated the markets with knock on effects in, for example, emerging markets. Late in the quarter, the loosening of the Syrian crisis also weighed on markets.

Against this background, the total return on the FTSE World Index in local currency terms was -0.1%, in sterling terms -1.9%, in US dollar terms +0.1% and in euro terms -1.7%. Looking at local currency returns first, there were above average returns from the FTSE Australia Index which returned 5.2%, certain of the European markets and the FTSE USA Index which returned +1.0%. On the negative side, the FTSE Latin American Index returned -6.0% and the FTSE All World All Emerging Markets Index -4.2%. However, currency effects were quite marked in certain countries and regions which made, for example, sterling returns quite different in these areas. The strong local currency performance of Australia turned negative in sterling terms where the FTSE Australia Index returned -4.2%. A slight strengthening of the pound against the US dollar meant that a positive return of 1.0% in the FTSE USA Index in local currency terms turned into a negative one of 1.0% in sterling terms but the largest differences were seen in the FTSE Asia Pacific ex Japan Index (-0.4% local currency return becoming -5.1% in sterling terms), the FTSE Latin American Index (-6.0% becoming -14.8%) and the FTSE All World All Emerging Markets Index (-4.2% becoming -10.0%).

Not surprisingly the international bond markets were unnerved by these events. We will talk about this later but, if we look at the table of gross redemption yields on high quality ten year government bonds above, we note the substantial increase over the quarter. The yield on the UK gilt rose by 76 basis points to 2.79%, on the US Treasury by 59 basis points to 2.76%, and the German bund by 35 basis points to 1.86%. Japan was an exception with a drop of 13 basis points to 0.73% against the background of a very aggressive monetary policy stance outlined in previous reviews.

In the currency markets, the Australian dollar remained weak with sterling showing a 9.9% rise against it. Sterling also rose by 3.7% against the Canadian dollar and by 2.0% against the US dollar. It rose marginally against the euro by 0.2% but fell 1.0% against the Swiss Franc and 0.7% against the yen.

In the commodity markets, oil reflected the Middle Eastern situation and, as measured by Brent Crude, rose by 13.6% whilst gold hardly moved.

ECONOMICS

Stock markets are finding the going rather tougher now than they did in the first quarter of the year when shares showed a significant rise. The reason seems paradoxical. The economic news has improved in a number of countries and, put very simply, good news has become bad news for the markets in terms of its implications for monetary policy. We continue to believe that shares remain

the best of the mainstream assets to hold but, as we have noted before, the big rise in equity markets from their nadir in March 2009 has not necessarily occurred for the best of reasons, with shares (and other asset classes) being pumped up by very aggressive monetary policies involving extraordinarily low interest rates and newly created money. So bad were economic and financial conditions that policy makers had to resort to this extreme economic policy measure to stabilise the relevant economies and, in this, they have largely been successful. Of course, economic conditions remain very difficult and the world economies are by no means out of danger yet, but cheap money has had the effect of raising asset prices, an aim of policy, to boost the confidence of individuals, as consumers, and businesses, as investors. Once all this extra money gets put to use, and it has not really done so yet, the danger of an upturn in inflation is quite obvious. So far, the sugar rush of cheap and newly created money has benefited securities but quantitative easing has to be throttled back and eventually reversed if severe inflationary problems are not to appear.

The reaction to Mr Bernanke's suggestion in June that, under certain circumstances, the Federal Reserve may start to taper its quantitative easing programme, those circumstances depending upon the economic data, suggested a state of denial amongst some investors. It is as if some investors tried to blank off in their mind the knowledge that quantitative easing could not last indefinitely so when the possibility of tapering was mentioned they reacted as if it was an unforeseen possibility.

Investors should remember that quantitative easing is not a mainstream economic policy, rather it is an exceptional emergency measure and certainly has some serious disadvantages. We have mentioned one major one, namely its inflationary implications if not terminated in a timely manner. Another is the distortion of markets. One distortion is that savers who invest in cash deposits and bonds experience economic hardship in many cases. Those buying annuities on retirement have been badly hit by very low interest rates. On the other hand, business borrowers who would not normally remain in business are kept afloat by virtue of low debt servicing costs. These so called "zombie" companies damage the prospects of viable companies and limit the latter's expansion. This is economically inefficient. Another bad side effect is that market distortions increase the prospect of a sharp fall in asset prices. Currently, the bond market is a good example of this point. Although it has had a significant setback recently after yields reached absurdly low levels, yields, in our view, still remain far too low and bond holders risk further significant negative returns. Sudden sharp moves in security prices can affect economic sentiment and damage economic prospects. Linked to the inflationary threats mentioned above are the effect on one specific area of the market, housing. We know this to have been the originator of the financial crisis in the USA, leaving many home owners with negative equity and lenders facing nasty losses as prices collapsed. In this respect, there are concerns in the UK about the government's "Help to Buy" scheme which, if it goes wrong, could leave the taxpayer with a hefty bill on the government guaranteed part of the loan. For company pension schemes, very low government bond yields mean very low discount rates on future liabilities meaning that companies may have to direct money from investment to top up their company pension schemes. Resources are more efficiently allocated at normal levels of interest rates, not highly artificial ones administered as part of very loose monetary policy.

Of course, equities, our favoured asset class, have benefited from quantitative easing, so why, it may be asked, do we favour them but are so negative on bonds? Equities have certainly benefited from inflows of money that may not normally have been aimed at their asset class but where the dividend yield advantages have overcome natural caution. One obvious point is that an investor has to invest somewhere even if it means keeping everything in cash. In many countries, however, that means suffering negative interest rates so that, for the foreseeable future, the real value of a portfolio will fall. Such a policy, in investment terms, suggests a highly negative view of the

economic outlook such as would suggest the optimal policy is to lose less than in other assets. However, such an investment would be preferable to investing in bonds where we see negative real returns being much higher than on cash and we cannot envisage circumstances where yields will then retrace their steps to fall back even to where they are now, let alone where they have come from. Equities may, of course, move lower but, in our view, they have a much better chance of recovering more quickly and then moving further ahead. Whereas bond yields look unrealistically low given the risks involved, we think equities still offer value, notwithstanding their strong recovery because valuations still look reasonable and we do not see the world economy collapsing. That is important because those with negative views on the equity market will back up their judgement by suggesting that profits and profit margins will revert to mean leaving cyclically adjusted price/earnings ratios too high to offer value.

So the key to a smooth transition from full blown quantitative easing to normality, a very long journey, is no surprises and a carefully signalled monetary policy, which is what the main central banks are trying to do. They can control very short term interest rates but the further along the yield curve they go, the more difficult it is when market forces come into play. If involved in quantitative easing, central banks can try to buy bonds with longer maturities but they need to employ increasingly large amounts of newly created cash to do so and, even then, success is not guaranteed. Besides, it is also a risk to a central bank's balance sheet if they sell the bonds at a loss as they unwind their bond purchases.

As our table at the beginning of this review shows, bond yields, in this case ten year benchmark government bond yields, have risen sharply over the quarter. It is easier to see this happening in the USA. It is the first country to talk about the running down of quantitative easing but because the economy seems to be improving, it would be perfectly normal for interest rates to start rising and a healthy sign which need not be negative for the equity markets. It has negative implications for some people, however, as mortgage rates which are priced off bond yields start to rise. But whilst the upturn in US bond yields, even against any reduction of the exceptional monetary policy measures which has so depressed them, is logical against the background of an apparent improvement in the US economy, it is highly inconvenient for other economies, especially the eurozone and the UK, to a lesser extent, with Japan being rather a law unto itself when it comes to bond yields given the extreme monetary policies in place and being planned for the economy.

As we shall see, there is slightly better news from the eurozone although the crisis still remains. However, the last thing it wants is for bond yields to be rising given the financing needs of the weaker members of the eurozone. If they are on the margin of not being able to refinance themselves, the extra costs might be the deciding factor and, if they are shut off from financial markets, higher rates might make it more difficult for them to re-enter them. For, with no growth to speak of in the eurozone, outstanding public debt keeps rising until the country in question finds it impossible to refinance itself and will have to apply for a bail out. Although the politicians and officials connected with the eurozone are trying to talk up the economic numbers and give the impression that the crisis is abating, they are talking their own book. Everything is effectively on hold until after the German election, for it is Germany which calls the shots, and once the election is over, things may start to happen.

Talk of the Federal Reserve perhaps starting to taper its QE programme because of an improving economic position and the resultant rise in bond yields, which has spread beyond the U.S. Treasuries market, threatens to damage economic recovery in areas like the eurozone. But rising bond yields from completely unrealistic levels and the resulting distortion to international financial

markets, which this caused, is now having another predictable side effect. In their search for yield, investors went down the quality scale in the bond markets so that these markets then failed to price in the risk which investment in them entailed. In the earlier years of QE, money flowed into emerging markets, more lowly rated sovereign bond markets and junk bond markets pushing up bond prices and therefore reducing bond yields. The threat of a tapering of QE is causing an abrupt reversal of this trend causing problems for emerging markets as money is pulled out of them and bond yields rise and their currencies fall. Many investors ignored the fundamental issues which should be considered before chasing what would seem to be attractive yields. A good example is India, previously considered, with China, to be a positive force for economic growth in the world economy given its size and growth rate. But the wheels have fallen off for India and it is not difficult to see why this has happened. It has a large current account deficit of around 4.5% of GDP. As long as there is confidence in an economy, that level of deficit can be financed through capital inflows, but if confidence weakens, the currency becomes vulnerable which is what is happening to the rupee now. Inflation is also a major problem. The latest inflation rate is 9.6%. So India is losing competitiveness at a rapid rate and the weakening currency will help in the short term in this respect. High levels of interest rates could stabilise the currency if there was a reasonable level of confidence in the economy which there is not now. Against this background, there has been a rapid falling off in India's economic growth rate which is now running at below 5%. If there were much hope of action to improve the economic outlook, that might help, but India is notoriously difficult to govern and desperately needed supply side reform proposals nearly all meet with opposition from vested interests. So, in this economic world where investors are having to take a lot more note of economic and political fundamentals, countries like India do not tick many boxes, hence the current rupee crisis. In contrast, China has a significant current account surplus. If we look at the previously favoured markets where investors were attracted by high yields, we note South Africa with a very large current account deficit, nearly 7% of GDP, Brazil, just over 3%, Turkey, nearly 7%, and Indonesia, almost 2.5%. Coupled with relatively high inflation (the same issue as we discussed for India), these countries have a second vulnerability. South Africa's inflation is running at 5.6%, Brazil's at 6.5%, Turkey's at 7.4% and Indonesia's at 7.7%. These are basic economic numbers which should always command attention but, in good times (for the markets that is and not necessarily reflecting the economic situation), they can often be ignored, with expensive consequences. The current turbulence in some emerging bond markets reflects a reaction to the extreme distortionary effects of QE and the artificial demand for assets, such as those described above. The danger is that the turbulence in bond and currency markets, if it continues, could reduce economic growth rates in these countries and spill over elsewhere.

Paradoxically, however, the rise in bond yields may extend the life of QE at its present level in the USA because rising bond yields signal monetary tightening which, in turn, could lead to a slowdown in economic growth. The present turbulence in bond markets shows just how difficult a balancing act it is to manage expectations on monetary policy and the move to reducing the amount of assets purchased under, in this case, the USA's QE programme (tapering) before stopping it altogether in phase 2 and, in phase 3, starting to reverse it by selling back assets to the private sector. An interesting theoretical question arises here, however. Because central banks can effectively control very short term interest rates but not so easily longer term rates, as we have been seeing recently, we have seen a steepening of the yield curve with the gap between short term and long term rates increasing. Normally, this would signal an economic recovery whereas the opposite would apply if the yield curve was downwards sloping. Whilst, so far, we have been concentrating on the quantitative easing aspect of monetary policy, we should not neglect the central bank's signals that short term interest rates will be kept very low for the foreseeable future. With central banker benchmark short term interest rates kept very low and well below inflation levels, we can

confidently say that, in normal times, these rates would be significantly higher and that, therefore, because of its distortion, the yield curve's signals are not clear. In normal times, the whole yield curve ranging from very short term interest rates to very long term interest rates would be shifted upwards with the ratio between short term and long term yields more subjective. In attempting to give clarity to their future intentions by establishing the ground rules for the setting of short term interest rates, central bankers may feel disappointed about the reaction in bond markets.

The result of all this is that we appear to be in the rather strange position that good news is bad news for markets and vice versa and this is a function of the negative side of the extreme monetary policies which have been followed in many countries. Normally, investors would react well to early signs of better economic times and vice versa but, instead, they have concentrated on the possibility of the start, manifested by possible tapering, of the eventual unwinding of QE and its implications for interest rates. As we saw, in the early part of the year, when there was less economic optimism, share prices performed strongly because, at that time, investors were not actively contemplating early action to start reversing QE. The lack of synchronisation of the economic fortunes of some important countries and regions is a problem in this context. Whilst the US economy is showing signs of improvement so that the Federal Reserve can at least consider tapering, the rise in bond yields (there is no suggestion of short term interest rates being raised) could worsen the position for, say, the eurozone, the UK and countries which benefited from inward flows of money resulting from QE but are now seeing the position reversed.

Let us now look at the position of different countries and regions, starting with the USA where second quarter growth registered an annualised rate of 2.5% having been revised upwards from 1.7% over the previous quarter and a 1.4% year on year rate. The latest IMF forecast for 2013 suggests a growth rate of 1.7% accelerating to 2.7% next year. There is some buoyancy in the employment market, one of the yardsticks which the Federal Reserve is using as a guide to when it might consider moving to a higher monetary policy. At 7.4%, however, the rate is well off the Federal Reserve's target of 6.5%. The closely watched Purchasing Managers Indices produced by the ISM also give some encouragement. The latest index for manufacturing (August) rose to 55.7 from 55.4 and that for non manufacturing (July) to 56.0 from 52.8, both well above the 50 level which marks the boundary between expansion and contraction. The latest trade figures also point in the right direction. June's trade deficit was its lowest since October 2009 with exports reaching an all time high and imports falling. The gap narrowed from US$44.1 billion in May to US$34.2 billion in June. Importantly, the housing market is now recovering. The S&P/Case Shiller Index measuring house prices in 20 major cities is almost 12.2% higher than a year earlier. Whilst sharp rises in house prices might flash warning signs for inflation and overborrowing in the USA, after what has happened to the market and the problems that collapsing house prices caused from 2008, it has the potential to give a positive wealth effect just as long as it does not get out of hand. The USA has to find a correct balance between reducing its budget deficit and stalling growth as a result of the measures taken to try to rectify public finances. Although the USA has the advantage of issuing the world's largest reserve currency which should make it less vulnerable (although certainly not invulnerable) to currency attacks, since foreign governments have little option but to hold substantial amounts of US dollars in their reserves, it still has to deal with the deficit. The unedifying arguments between the two political parties in the USA have resulted in tax increases and sequestration affecting government programmes but, contrary to all the dire warnings, the economic roof has not fallen in. It would not be true to say that everything has gone quiet in Washington and it may be a while before the debt ceiling storm blows up but, at the moment, the USA's budget deficit woes have moved off centre stage. There are, however, problems in local government as Detroit's bankruptcy shows and this issue is set to grow as more municipalities are

likely to face financial problems often arising from very large pension liabilities. The USA's budget deficit is expected to be around 4.5% of GDP this year, still too large but a vast improvement on what it was before. But in the absence of moves to address enormous future entitlement liabilities, the problem will return in a big way. Although off their recent high point, US equities have performed very well this year at a time when the rate of corporate earnings growth has slowed down. Companies in the USA, as elsewhere, have seen their earnings benefit by keeping a close lid on costs following the economic crisis but now they need to see revenues grow. The current thinking as, for example, evidenced by the recent IMF World Economic Outlook update in July, indicates some modest acceleration in world growth next year to 3.8% from 3.1% this year, although both projections are 0.2% lower than in its previous April forecast. An acceleration in economic growth, as a broad generalisation, should improve companies' revenue position in the USA, as elsewhere. As before, notwithstanding the sharp rise in, say, 10 year US Treasury yields, we think that US equities retain their attraction.

Some slightly better or, more accurately, less bad news from the eurozone has caused politicians and EU officials to talk up prospects for the eurozone starting to get on top of its problems but reality has never played a great part in their forecasts, so determined are they to keep the eurozone together. In many past reviews, we have detailed why the eurozone is not an optimal currency zone - the countries comprising it are just too different in every way for them to converge economically as planned. In very broad terms, it will only really work if one could imagine the eurozone as one giant country with one economic government but it is evident that there is no democratic will for such an institution as voter support for the eurozone and EU wanes. One only has to look at some of the eurozone's unemployment rates to see what a lost cause it is, Greece at 27.6%, Spain at 26.3%, Italy at 12.1% and France at 11.6%. Then one looks at the level of outstanding public debt with which some of the eurozone countries are burdened to see that, in the absence of any reasonable growth prospects, outstanding levels of debt are going to increase until more are shut out of the markets. According to the latest Eurostat figures for outstanding government debt as a percentage of GDP, the overall eurozone level is a dangerously high 92.2%, with Italy at 130.3%, Portugal at 123.6%, France at 91.9%, and Spain at 88.2%. If these countries are not growing at a certain rate, their debt will increase and the situation will further worsen if interest rates in the more highly rated countries rise to more normal levels with a knock on down the quality chain and it will increase debt servicing costs. With the ability to retain their own currency having been given up, drivers of growth in these countries, which may have been stimulated by devaluation, have been denied to them. There is little doubt that some countries in bail out and additional ones which are likely to seek help will give eurozone leaders plenty to think about. As this is written, it is interesting to note that Wolfgang Schäuble, the German Finance Minister, as much as said that Greece will need a third international bail out. The surprising thing is that he said this before September's federal election. Everyone who follows the Greek situation knows this has to happen but no one wanted to upset the applecart before the German election because the subject is so sensitive for the German electorate.

This structural issue has been, remains and will continue to be the fundamental problem for the eurozone but what is it that has made the politicians suggest that things are improving? After six quarters of economic contraction, the second quarter saw very modest growth of 1.2% at an annualised rate but down 0.6% year on year. France saw annualised quarterly growth of 1.9% but down 0.3% year on year. Germany saw annualised quarterly growth of 2.9% and a year on year increase of 0.3%. Italy saw an annualised quarterly decline of 1.0% and a 1.9% contraction year on year. For Spain, the annualised quarterly decline was 0.4% and, on a year on year basis, the decline was 1.6%. Even a top rated credit like the Netherlands is struggling with an annualised quarterly

contraction of 0.7% and a year on year contraction of 1.1%. For Portugal, which has been experiencing great hardship, there was better news last quarter with a quarter on quarter growth rate of 1.1%. Although the eurozone authorities have reduced the pace of the austerity measures required by some of the relevant eurozone economies, the policy of austerity and internal devaluations is a very high price to pay for some countries in terms of social hardship. The unemployment rates we quoted for some of the most affected countries will surely find their resentment in the ballot boxes and we continue to doubt that the eurozone can hold together. Even relatively strong countries like the Netherlands which, as we have seen above, are experiencing a very difficult time, are starting to turn against the euro project and this in a country which was more pro euro than most. However, as we have often said before, we must distinguish between eurozone domiciled companies and the sovereign with many world class companies based in the area. Eurozone market ratings tend to be modest and, in our view, eurozone equities are much more attractive than euro denominated sovereign bonds. On dividend yield grounds alone, the advantage of eurozone equities, as a class, appeals.

Japan is in the early stages of its extreme monetary policy experiment to which we alluded earlier and the next policy decision is whether to press ahead with the two stage sales tax increase to 10% by 2015. With gross public debt at around 242% of GDP and net public debt at around 154%, the decision obviously carries a risk either way. If it is deferred, there is a clear risk to the bond market. For, if the Bank of Japan succeeds in reaching its 2% inflation target, one would expect investors, in normal circumstances, to want a real return. In a deflationary environment, yields of below 1% on government bonds are not as ridiculous as they seem. If bond yields were to reflect rising inflation then servicing costs would gradually rise, exacerbating the problem. The second risk is that, if efforts are not made to plug the budget deficit, expected to be over 8% of GDP this year, the bond market may take fright for that reason as well. The contrary argument is that if the sales tax increases are brought in, 3% next year with the other 2% following in 2015, the economy will weaken and the measure will prove self defeating. The Governor of the Bank of Japan has given his support to the sales tax increase. In an ideal world, the very loose monetary policy being followed will outweigh the tightening of fiscal policy. We may know the sales tax decision in early October. Meanwhile, there was some slightly disappointing news on second quarter growth which came in at an annualised rate of 2.6%. This followed a figure of 3.8% in the first quarter, a level which had been revised downwards from 3.8%. Looking at the composition of second quarter growth, exports and household consumption were strong but manufacturers drew down inventories which was a negative driver and business investment continued to fall. Although one month's figures should not be statistically significant, there must be some disappointment, given the fall in the yen, that exports fell a seasonally adjusted 1.8% compared with June. We would give the benefit of the doubt to Japanese manufacturing companies in that, where they have not been compromised by foreign competition, the economic background should be helpful to their profits prospects.

China is as important as ever in shaping investors' expectations about the markets, given subdued economic activity in many countries. China is trying to adjust the profile of the economy more towards consumption and away from fixed asset investment, property and exports. The slowdown, which has recently been in evidence in the Chinese economy, has caused some consternation amongst investors but recent news has been slightly better. There was strong growth in trade in July with exports rising by 5.1% year on year compared with a 3.1% fall in June. Imports were up 10.9% in July on a year earlier, compared with a 0.7% fall in June. The news from manufacturing was better in July. Industrial production from large enterprises was 9.7% higher in July than a year earlier with the previous month's figure being 8.9%. Power production is often considered to be a useful indication of the strength of the Chinese economy and there is some evidence of strength

from the latest figures. Power production in July was 8.1% higher in July than a year earlier against 6.0% in June. But two areas which the Chinese authorities want to curb, fixed asset investment and real estate, still showed strong growth. The HSBC "flash" Purchasing Managers Index for manufacturing for August has come in at 50.1 up from 47.7 in July. So there is some encouragement from China and at a time when there are problems in some emerging markets. China's financial and economic strength is some counter. Most countries can only look on with envy at China's 7.5% year on year increase in GDP.

For the UK, the economic numbers have nearly all been encouraging albeit from a low level. Weakness in the eurozone remains unhelpful but there is evidence that UK companies are doing better in other markets. The latest estimate of second quarter growth has been revised upwards to 0.7% from the initial estimate of 0.6%. Encouragingly, exports contributed 0.3% to GDP growth. This could be significant given the government's attempts to rebalance the economy. In analysing the second quarter growth figures, the Office for National Statistics has reported that manufacturing grew by 0.7% in the second quarter and construction growth by 1.4%, both of these figures being higher than in the first estimate of second quarter GDP. Besides exports, the government wants business investment to drive the economy. In the UK, as elsewhere, companies have been accumulating cash but have held back from investment until the economic outlook becomes clearer. In this respect, there is some modest encouragement for the government in the ONS's statement that business investment increased by 0.9% over the quarter compared with the first quarter of the year, although it was 3.5% lower than twelve months previously. The rather better growth figure fits in well with some encouraging purchasing managers indices for the UK. The August manufacturing PMI came in at 57.2 against 54.8 the previous month, the services PMI at 60.5 against 60.2 and the construction PMI at 59.1 against 57.0. Other figures which paint a more encouraging picture of the economy include the UK motor industry, a big success story, raising its annual sales forecast as sales rose for the seventeenth month in a row. Although very patchy, with London almost being like a separate country, there is every indication of a more buoyant housing market. Mortgage advances are stronger. In the second quarter of the year, the largest number of mortgages was advanced for 5 ½ years, according to the Council of Mortgage Lenders. In July, it said that gross mortgage lending was at £16.6 billion, up 12% from June, and the highest level since 2008. Although still too high, the unemployment rate at 7.8% compares relatively favourably with the eurozone. It is to try to encourage "animal spirits" amongst business and individuals and the Bank of England is trying to give as much forward guidance as it can to create some certainty for decision makers. We mentioned just now business investment which the government (not just that of the UK) would like to encourage. So the Bank of England has indicated that it will keep interest rates very low until unemployment falls to 7%, 0.8% below the current level with 2016 as its time frame for that to happen. Its other "knockout" caveats related to inflation, inflationary expectations and financial stability.

These are certainly some encouraging signs emanating from the UK but these come from a low base and no one should underestimate the problems of the world economy, especially the eurozone, which provide a drag on economic growth. We should also remember the difficulties which the government is having in getting a grip on the budget deficit. Up to the end of July, public sector borrowing was £1.6 billion higher than in the equivalent period the previous year. Deleveraging by the government and individuals provides a drag on growth which is why the government will be doing its best to provide a background where businesses might be keener to invest and hoping that the UK can find higher growth export markets to offset difficult conditions in the eurozone.

Finally, and very importantly, back to the economic fall out on some emerging markets from the possibility of the US Federal Reserve starting to taper its QE programme. In the earlier stages of QE, money flowed into emerging markets in search of higher returns pushing up currencies, bond yields down and causing some countries like Brazil to take action to try to restrain the upwards pressure on their currencies which threatened to damage its exporters. Sufficient attention was not paid to the economic fundamentals of these countries. Now as US bond yields rise, money is leaving emerging markets causing severe currency weakness in a number of countries like India, Brazil, Turkey, South Africa and Indonesia. Those with significant current account deficits, which need to be financed, are particularly vulnerable. Failure to undertake significant structural reforms in the good times will hamper economic recovery, India being a good, but not only, example. So, for the moment, investors, as our table at the beginning of this review shows are favouring developed markets. Sentiment can change very quickly in stock markets and we are mindful that, notwithstanding the difficult times which some emerging market economies are now facing, their longer term growth rate potential remains greater than that of most developed economies. It would be unwise to discard this exposure from an international equity portfolio.

In summary, there are conflicting factors influencing markets in the short term. On the positive side, a number of countries are producing better economic figures and, for a good quality rise in the stock market, it is economic growth which is needed to support share price rises because that will lead to profits growth driven by revenue increases, rather than, as has often been the case recently, by cost reductions. The latter can only go so far. On the negative side, we see rising bond yields which imply monetary tightening, continuing eurozone problems, concerns about some emerging markets and Syria. With equities remaining attractive against bonds, we see volatility around an upward trend with any periods of weakness occasioned by bad news providing an opportunity to top up equity holdings. Notwithstanding the rise in bond yields, we find yields still a long way off being at an interesting level at which to buy bonds.

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